Supreme Court, U.S.
FILED
APR 17 1998
CLERK

No. 97-1491

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1997

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, et al.,
Petitioners,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, et al.,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE COURT OF APPEALS
OF THE STATE OF NEW YORK

PETITIONERS' REPLY TO RESPONDENTS BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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I. OVERVIEW OF RESPONDENTS' ARGUMENT

Respondents in their opposition to the Petition for Certiorari continue their fabled, smoke and mirror argument that federal regulation of "free credit balances" has:

> 1. Assured an efficient and economical system for the execution of securities transactions;
> 2. Accomplished certain objectives of Congress which establish a "coherent regulatory structure" for a national securities market system; and
> 3. Prevented the "upset [of] the policy-based delicate balances" that Congress has directed the SEC to achieve by regulation and structure of cost-effective and orderly securities market systems, citing as their main case Guice v. Schwab, et al., 89 N.Y. 2d 31, 352 674 N.E. 2d 282, 289, 651 N.Y.S. 2d 352, 359, c.d. 117 S.Ct. 1250 (1997) and additionally enhancing the Guice arguments with a tortured analyses of the history or "free credit balance" rule making.

In furtherance thereof, Respondents have tried to liken their linchpin case of Guice supra, which is a "disclosure" issue case, to the instant matter which has nothing to do with disclosure. (See Pet. for Cert., p. 16) It is difficult, if not impossible, to perceive any linkage between existing federal regulation or the history of such regulation and the unilateral arrogation by the Respondents of all of the benefits arising from the use of free credit balances as well as the simultaneous extinction of all state and federal civil remedies for such acts.

II. THE DIFFERENCES BETWEEN THE ORDER FLOW PAYMENTS AT ISSUE IN GUICE AND THE UNILATERAL USE OF FREE

CREDIT BALANCES IN BRAUNSTEIN AS A CLAIMED "NECESSARY AND LEGITIMATE" MEANS OF CARRYING ON CUSTOMERS' BUSINESS

Order Flow Payments are compensation for services rendered by one broker for another; those payments are consideration for the execution of security transactions. Order flow payments are inducements accepted by brokers from market makers (wholesale securities dealers) in exchange for directing customer order flow to the market maker. The breach alleged in the "order flow" and "best execution" cases akin to Guice arise from the broker-dealers' duty of "best execution," which is not implicated by the Braunstein claims. Payment for Order Flow, Exchange Act Release No. 34902, [1994-95 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶85,444, at 85,854 n. 28 (Oct. 27, 1994) ("SEC Rel. No. 34-34902").

Order flow payments are distinguished from free credit balances in several significant respects. Unlike free credit balances, order flow payments: (1) are directly related to the streamlining of procedures for the purchase and sale of securities; (2) are directly related to a broker's rate and commission structure -- an area over which the SEC has exclusive control; (3) have been the subject of continuous and extensive study by Congress and the NASD, as well as the SEC, which has expressly adopted a policy permitting the practice; and (4) are an "efficiency" vehicle to assist the "national market system for securities and . . . for the clearance and settlement of securities transactions," which was the purpose of Congressional amendments to the Securities Exchange Act in 1975. None of these factors exists here. Yet Respondents continue to argue that the unrestricted use for their own benefits of their customers' funds in some way has not only been sanctioned and blessed by the SEC, but additionally, they are prohibited by some SEC regulation from paying any benefits to the beneficiaries and owners of "free credit balances," i.e. those who have provided such funds.

They do argue - correctly - that there is "no provision for compensation to customers" of any broker-dealer income resulting from the usage of "free credit balances." (Resp. Brief at p. 13-14). Respondents also equate the permissive use of those balances as an absolute right to all of the fruits of such usage. Finally, they say that the SEC has been pervasive in its legislation and rule making in this regard - even though such a strident position contradicts their above referenced admission that there is "no provision for compensation to customers." All of this equates - Respondents say - to federal preemption when, in fact and law, it is a complete absence of federal control.

III. A COMPLETE ABSENCE OF CONGRESSIONAL AND SEC REGULATIONS REGARDING COMPENSATION TO CUSTOMERS FROM THE USE OF FREE CREDIT BALANCES DOES NOT EQUATE FEDERAL PREEMPTION NOR THE EXTINGUISHMENT OF ALL RIGHTS OF REDRESS

The usage of the benefits of Free Credit Balances have nothing to do with services performed by Respondents for anybody - except themselves; it is a double payment for Respondents' required brokerage functions which have already been paid for by the charging of commissions. The free, unfettered use of customers' funds has never been regarded by the SEC as an area to be regulated; it was always considered a matter between the customer and the broker and not a matter of regulatory concern. (Pet. App. S, A189-191 and App. T, A192-195, Petition for Certiorari). This "custom" hardly rise to the level of a "necessary and legitimate" means of carrying on customers' business as the Respondents have argued to this Court. (Resp. Brief, p. 8).

A. Right Of Redress

In Respondents' Opposition Memorandum their assertion

that common law claims relating to Respondents' profiting through the use of their customers' free credit balances are preempted by federal law is erroneous. Should the Court accept Respondents' position in this regard none of the customers of Respondents would have any right of redress for Respondents' breach of fiduciary duty and unjust enrichment in any court, federal or state.

On the one hand, there is no federal remedy since the SEC has consistently held that "the payment of interest by broker-dealers on free credit balances that arise as an incidence of customers securities activities is a business matter between a broker-dealer and its customers and normally will not raise regulatory concerns." SEC Rel. No, 34-18262, [1981 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶25,134B at 18,327 (Nov. 17, 1981) (Appendix S). On the other hand, according to Respondents the pervasiveness of the federal regulatory scheme would preclude any state claims. In such a scenario, the SEC's statement that money earned on a customer's free credit balance is a "business matter between a broker-dealer and its customers and normally will not raise regulatory concerns" would be superfluous. "Business matters" between a customer and a broker-dealer, including those relating to customers' free credit balances have traditionally been litigated at the state level. Horst v. W.T. Cabe & Co., [1977-78 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶96,213 (S.D.N.Y. October 31, 1977); Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 101 Misc. 2d 655, 421 N.Y.S.2d 794 (S.Ct. N.Y. Co. 1979) and Id., 93 Misc. 2d 941, 404 N.Y.S.2d 258 (Sup. Ct. N.Y. Co. 1978). This was recognized by the SEC and any other interpretation would render meaningless the SEC pronouncements.

B. Absence Of Regulation v. Choice To Not Regulate

Respondents' alternate theory regarding preemption incorrectly draws a distinction between the absence of regulation as articulated in Freightliner Corporation, et al. v. Ben Myrick et ux, et al., 514 U.S. 280, 115 S.Ct. 1483 (1995) and a regulator's choice to not use the authority to regulate. The cases cited by

Respondents are inapposite both on the law and the facts. Contrary to Respondents' position, Ray v. Atlantic-Richfield, 435 U.S. 151, 178, 98 S.Ct. 988, 1004-1005 (1978) does not stand for a universal proposition that a federal agency's decision to not utilize its authority to regulate operates as an automatic preemption of state law. In fact, this Court has traditionally permitted a state to enforce laws that have a purpose different from the purpose of regulating behavior adopted at a federal level. Ray, 435 U.S. at 164, 98 S.Ct. at 998 ("the mere fact that a vessel has been inspected and found to comply with the Secretary's vessel safety regulations does not prevent a State or city from enforcing local laws having other purposes, such as a local smoke abatement law.") Petitioners' common law claims of unjust enrichment and breach of fiduciary duties are not in any way premised upon any federal regulation of behavior in regard to the brokerage industry's use and disclosure of free credit balances and do not conflict with any purpose of federal regulation.

Essentially, Ray and Respondents' other authorities have described a conflict preemption analysis which Petitioners have already addressed. Moreover, the SEC has not simply chosen to not regulate the profits earned by broker-dealers from their use of free credit balances, they have stated affirmatively such a use in a "business matter" between a broker-dealer and a customer "not of regulatory concern." This fits perfectly with the language of the savings clause of the 1934 Act which specifically authorizes state claims at common law and equity. (Section 28(a) of the Securities Exchange Act of 1934 [15 USC §78bb(a) (1993)]).

IV. RESPONDENTS ARGUMENT THAT EXPOSURE TO CIVIL LIABILITY FROM EACH STATE WOULD UPSET A FEDERALLY MANDATED BALANCE REGARDING THE USE OF FREE CREDIT BALANCES IS SPECIOUS

Respondents' arguments in the Arizona state court action

which was stayed in Arizona at their request, vigorously pointed out that New York law - the reason for the need of New York venue - would apply to the subject transactions. A summary of those arguments regarding the Respondents' choice of law provisions in their stay or transfer motion follows:

Defendant (Respondents)	State of Incorporation	Defendants' (Respondents) Principal Place of Business and Choice of Law and Forum
Shearson	Delaware	New York
Kemper	Delaware	New York or Illinois
Smith Barney	Delaware	New York
Lehman Brothers	Delaware	New York
Prudential Bache	Delaware	New York
Paine Webber	Delaware	New York
Merrill Lynch	Delaware	New York
Kidder, Peabody	Delaware	New York
Dean Witter	Delaware	New York
Bear Stearns	Delaware	New York
Alex. Brown	Maryland	New York or Maryland
Charles Schwab	California	New York or California

Respondents' argument that should Petitioners' claims be given viability, an "undermining" of one "finely crafted" and "balanced" Federal regulatory structure would occur because each state would impose differing standards of liability, is transparent and illusory. Respondents should not be allowed an unlimited franchise in regard to free credit balances as Petitioners' contacts with New York clearly permit regulation of such commerce. Steinbeck v. Gerosa, 4 N.Y.2d 302, 319-20, 151 N.E.2d 170, 180,

175 N.Y.S.2d 1, 14-15, appeal dismissed, 358 U.S. 39 (1958) (rejecting Commerce Clause challenge to City's General Receipts Tax on residents). Indeed, Petitioners' contacts with New York clearly permit application of a unitary body of law to these claims. This court has endorsed such a procedure in national class actions. Philips Petroleum v. Shutts, 427 U.S. 797 (1985).

Finally, these claims of Petitioners in no way attempts to regulate Respondents' behavior. Respondents can proceed with their day to day business even though common law claims of unjust enrichment and breach of fiduciary duty are given viability.

A. Respondents Argue That The Facts Of This Litigation Are Not Likely To Recur: There Will Be No Self-Regulation

After pointing out the difficulty that rights of redress would cause to them if permitted, the Respondents then say they are discontinuing the practice due to some vague economic pressure or reform and that, further, they have no fiduciary duty to their customers.

Respondents claim that the practices for which the Petitioners seek redress are of "limited scope" and "decreasing practical importance" due to reforms in the brokerage industry. According to the Respondents, broker dealers now offer "sweep" accounts which automatically invest free credit balances in money market funds. In fact, these "sweep" accounts are computerized to permit at least an overnight delay, if not more; Petitioners have so alleged. However, the facts are not limited only to "sweep" accounts. The problems of delay of payment of cash funds to customers occurs in all transactions involving the collection by the broker of dividends, interest and proceeds from security transactions. The unilateral usage of free credit balances is at its greatest during the transaction wherein an account is transferred from one broker to another even though funds could be wired instantaneously. Petitioners have alleged these various techniques

including the "sweep" one-day delay practice or intentional delays in their Amended Complaint. (Pet. for Cert., A50-83). These claims of self-regulation by the brokerage industry are fantasies even if true do not compensate the public for past practices. Far from being of limited scope, the practice of using free credit balances encompass millions, if not billions, in improper profits made at the expense of tens of millions of securities customers (Pet. App. G at A55-56, 60). In fact virtually every account of the 30,000,000 accounts handled by the Respondents has been damaged whenever a free credit balance was created as a result of a securities transaction. (Pet. App. G at A51-53 and A63-66). This practice has not only been acknowledged by Respondents; it was proudly stated in their Memorandum in Opposition to Class Certification:

> "[T]he long-standing industry practice was not to pay benefits earned on free credit balances to the customer." (Pet. App. BB at A216).

Petitioners seek protection from such wide spread practices past, present and future as well as the payment of damages through enforcement of state securities laws and claims; Section 28(a) leaves the several states authority in this regard. Leroy v. Great Western United Corporation, 443 U.S. 173, 182 f.n. 13.

B. Respondents Deny The Trust Relationship With Their Clients

The Respondents make the argument that the broker acts not as a trustee for the customer's free credit balances, but rather as a debtor to the creditor (i.e., customer). Neither the Appellate Division nor the Court of Appeals addressed the trust issue; instead, only constitutional issues were addressed. Thus Judge Schackman's decision following established New York and state law generally stating that a trust relationship exists, should stand. But even if, for the sake of argument, the Respondents' position is considered, it does not stand up to close scrutiny. The Respondents' contention - that the practice of using free credit

balances is not a trust relationship - flies in the face of the universal belief of the courts, legal writers and the public. See Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 101 Misc. 2d 655, 421 N.Y.S.2d 794 (S.Ct. N.Y. Co. 1979) and Id., 93 Misc. 2d 941, 404 N.Y.S.2d 258 (Sup. Ct. N.Y. Co. 1978). For example, The Restatement (Second) of Trusts, §203 (1959) (Pet. App. DD at A240-241) states clearly:

> ". . . (a) trustee is accountable for any profit made by him arising out of the administration of the trust, regardless of whether he entered into the transaction with the intent of making a profit for himself or not, and regardless of the fact that he commits no breach of the trust in so doing."

Moreover, this Court in United States v. Mitchell, 463 U.S. 206 at 225, 103 S.Ct. 2972 recognized the unassailable principle that "a trustee is accountable in damages for breaches of trust." This concept has remarkably escaped the securities industry's treatment and perception of free credit balances; it should not be allowed to continue.

V. THE COMMERCE CLAUSE DOES NOT APPLY TO THE CLAIMS ASSERTED HERE

Even under a "traditional" commerce clause analysis, Defendants' argument must fail. The Commerce Clause was intended to "prohibit economic protectionism -- that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." West Lynn Creamery v. Healy, 512 U.S. 186, 114 S.Ct. 2205, 2211 (1994). This Court has never suggested that the Commerce Clause requires each state's law to stop at its border. Regan, Siamese Essays: (I) CTS Corp. v. Dynamics Corp. of America and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation, 85 Mich. L. Rev. 1865, 1878 (1987) ("prohibition [of all state laws that have substantial extraterritorial effects] would invalidate too much

legislation").

The retention of the benefits arising from their use of free credit balances, are not transactions that implicate interstate commerce and, thus, do not fall within the protection of the commerce clause. These activities are separate and distinct from any interstate securities transactions which might be protected by the Commerce Clause. Free credit balances arise as *an incidence of* securities transactions, but are not necessary to their execution. As one New York court has said, "if it can be said to affect interstate commerce in any way it is incidentally, and so remotely as not to amount to a regulation of such commerce." Steinbeck, 4 N.Y.2d at 319-20, 151 N.E.2d at 180, 175 N.Y.S.2d at 14-15, appeal dismissed, 358 U.S. 39 (1958).

VI. CONCLUSION

For the reasons stated in the Petition for Certiorari and in this Reply Brief, Petitioners request the Court to grant said Petition.

Dated: April 17, 1998

Respectfully submitted,

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